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**J. Benjamin Johnson**  
Chief Executive Officer

February 7, 1997

Peter Christnacht

MMS

Valuation and Standards Division

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Sent via FAX: 303-275-7227

RE: Comments on proposed crude oil payment regulations

Dear Peter:

We would like to offer some comments and suggestions regarding the proposed crude oil payment regulations set forth in your draft Notice of Proposed Rulemaking which was sent to us on January 24, 1997. We have noticed that most of our earlier suggestions have been incorporated into your newest proposal, and we applaud your strong stance toward collection of the full oil royalty values due the US government. There were a couple portions of your proposed regulations, however, which we believe could result in considerable losses if implemented exactly as described in your Notice.

The first issue involved the possibility that a party could prepay for purchases of crude oil. This would be typical of a situation where a producer sells "call rights" to another party who is then given the right to buy a certain amount of lease crude oil at posted price (which would be discounted to the actual market value). As we understand the new proposed MMS regulations, the amount of the prepayment would have to be allocated over the oil as it is produced and sold, and the proportional prepayment amount would have to be added to the final sales price. Although this does account for the principal on the prepayment amount, it does not appear to account for interest accrued on the money. In effect, this gives the producers the opportunity to borrow money from the federal government for royalty payments at zero interest rate. We suggest that either any prepayment amounts must also be adjusted for accrued interest over the time between the prepayment and the final sales of the crude oil, or royalties should be due on the prepayment amount at the time of the prepayment.

The second issue involves the price basis for crude oil at Cushing, Oklahoma. As we discussed in our Denver meeting September 5, 1996, the actual delivered price of crude oil at Cushing is usually determined through one of three basic ways. First of all, the Cushing oil can be valued under a "P Plus" calculation. The actual delivery price would be the average of a reference posted price during the month of delivery, plus a premium determined in advance of the delivery month, either through the cash markets or as a derivative of the NYMEX futures contract prices. While this first method yields a value consistent with actual arms-length crude oil commodity sales, it necessarily relies on a posted price which has been set arbitrarily and unilaterally by some oil company. The second valuation method would be to use the NYMEX futures prices for the delivery month. Under this second pricing method, the absolute price for oil delivered at Cushing would have been determined on the futures market prior to the beginning of the delivery month. This method also provides crude oil valuation which appropriately reflects the value received through actual arms-length commodity sales, but it necessarily reflects the prices determined in times prior to the actual delivery month. The third pricing method discussed in our 9/5/96 meeting was a hybrid of the first two methods, whereby the oil would be priced at the NYMEX prompt price during the month of delivery, plus a "Time Factor Differential" to account for the fact that the NYMEX is actually trading for future time periods during the month of delivery. As you will recall, the Time Factor Differential is calculated in advance of the delivery month, comparable to the way the P-Plus premium is calculated for the P-Plus delivery month.

As we understand it, your proposed base valuation for Cushing commodity crude oil for each delivery month would use the averages of the NYMEX settle prompt prices each day during the delivery month for as many trading days as the prompt month is the month immediately following the delivery month. While this may appear to provide a simpler and

Summit Resource Management, Inc.

Page - 2

02/07/97

more understandable approach to pricing of the Cushing oil, it only partially accounts for the actual traded value of the Cushing crude and leaves a considerable arbitrage opportunity. This would result in lower royalty payments for the federal government. It is important to recognize that the NYMEX market trades *futures* prices, i.e. prices for delivery of crude oil in future time periods. The use of such futures prices without appropriate adjustments for time differences would allow sophisticated oil producers to execute the arbitrages when market conditions are favorable and refrain from arbitrages when the market conditions are unfavorable. The federal government would suffer by receiving less than the full realized value for its royalty oil.

The additional value resulting from the Time Factor Differential was shown during our meeting on September 5, 1996. This is basically the reason why the P-Plus market premiums are usually greater than just the Spot-Posting differential alone. As you may recall, we provided an example calculation for the month of October 1996 which showed that the use of the NYMEX prompt settle prices alone would result in a delivered Cushing price \$0.92/BBL lower than the use of the Adjusted NYMEX settle. Since our last meeting in September, we have performed this calculation for the time period of February 1989 through June 1994. This calculation is summarized in the table below.

TFD Average for 2/89 - 6/94 Cushing Deliveries	Time Factor Differential
Time Factor Differential average, including all months	\$0.17
Time Factor Differential average, including only months when TFD is positive	\$0.30

The values in the table show that by including the Time Factor Differential in the royalty payment basis for the Cushing price, over the subject time period, the federal government would have received \$0.17 per barrel more than simply taking the NYMEX prompt settle price. This also shows that, by agreeing to accept the NYMEX prompt settle price as the basis for royalty payment, the royalty payors would have been given the opportunity to arbitrage only when the markets allowed a positive arbitrage. This would have resulted in the royalty payors receiving an additional \$0.30 per barrel, on average, for the royalty oil over the base price accepted by the MMS as NYMEX prompt.

If you need clarification regarding the interest calculation or application of the Time Factor Differential, please don't hesitate to call or discuss it with me during our meeting in Denver next Wednesday. We believe that this is important in order to maximize royalty values to the federal government.

Sincerely,

  
J.B. Johnson